Canadian banks in the financial and economic crisis

Tony Porter
Department of Political Science
McMaster University, Hamilton Canada L8S 4M4
905-525-9140 ext. 21288
tporter@mcmaster.ca

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An interesting aspect of the 2007/2008 financial crisis was the remarkable success of the Canadian banks in weathering it as compared to banks in most other countries. Canada was the only G7 country that did not have a government bank bailout. Canadian banks remained profitable through the crisis. A World Economic Forum report ranked Canada first among 134 countries on the soundness of its banks.[1] Canada was widely applauded for its performance, including by US President Obama, who noted ñCanada has shown itself to be a pretty good manager of the financial system and the economy in ways that we havenôt always been.ò[2] Newspaper headlines like ñWhat Toronto can teach New York and Londonò proliferated.[3] Not surprisingly, this success has created a great deal of interest in looking to Canada for lessons on what policies and regulations should be put into place to prevent or manage future crises.

Also unsurprisingly, there is eagerness on the part of some who already have an agenda to look to the Canadian experience to try to validate that agenda, even when the Canadian lessons appear to be contrary to that agenda. Those, such as Obama, who favour stronger regulation look to Canadian regulatory strengths. The consistently market-oriented Fraser Institute has warned ominously about the risks associated with the strong government role in Canadian mortgage finance and has called for the privatization of the Canadian Mortgage and Housing Corporation (CMHC), despite the apparent success of the CHMC in stabilizing the market.[4] Simon Johnson, a prominent and vocal advocate of reducing the size of US banks that are too big to fail (TBTF) has been greeted with considerable skepticism in his attempt to discredit the argument that the very concentrated Canadian banking industry shows that we donôt need to worry about bank concentration.[5]

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[1] World Economic Forum (2008) *The Global Competitiveness Report*, Table 8.07, p. 456, at http://www.weforum.org/documents/GCR0809/index.html, accessed May 11, 2010.
[2] Quoted in Theresa Tedesco (2009) ñThe Great Solvent North,ò *New York* Times, February 27.
[3] Chrystia Freeland (2010) ñWhat Toronto can Teach New York and Londonò, *Financial Times*, Jan 29, at http://www.ft.com/cms/s/2/db2b340a-0a1b-11df-8b23-00144feabdc0.html, Accessed April 22, 2010.
[4] Neil Mohindra (2010) ñMortgage Finance Reform: Protecting Taxpayers from Liability,ò Studies in Insurance Policy. Fraser Institute, February. The report is discussed below.
[5] Johnson, former chief economist at the IMF, is known for his article on the capture by the financial industry of the US government: ñThe Quiet Coup,ò *Atlantic*, May 2009. His views on the TBTF issue are set out in Simon Johnson and James Kwak (2010) *13 Bankers: The Wall Street Takeover and the Next*

This paper seeks to contribute to this important but contested examination of Canadian practice. Despite the controversies, it is possible to identify a number of aspects of Canadian banking that seem particularly likely to have contributed to its stability. The likelihood that these aspects are important is supported either by widespread consensus on them among those who have commented on Canadian success, or by convincing empirical data. It is useful to summarize these, and this is the first task of this paper.

However the paper also seeks to move beyond the current consensus by making two arguments about how the Canadian experience should be viewed when seeking to draw lessons for other countries. Both these arguments warn against the tendency to try to transfer too casually practices that work in one settingð typically in a developed financial market and in this case in Canadað to all other financial markets in very different settings, including new financial markets in developing countries.

The two arguments relate to two overlapping but quite distinct problems with such transfers. The first is the importance of local context, history, and broader social structures: Canadian banking practices of the past few years were not solely the results of choices made by bankers and regulators in those years, but instead also crucially worked within a local Canadian context that had evolved over a very long time. In considering lessons to be drawn from Canadian practices it is important to consider the significance of these differing contexts in Canada and elsewhere.

The second problem is that the Canadian financial system, as with other national financial systems, is not an island for which distinctive national governance and business practices can be devised. The 2007-8 crisis itself originated in the United States and then spread disastrously though many other national jurisdictions. Official and business actors in any particular national jurisdiction increasingly operate within a larger transnational system in which they have collective interests and responsibilities. Thus even a practice that worked well in the Canadian context may be best to change if the benefits for Canada from transnational harmonization around a different practice outweigh the more purely national benefits of the existing practice. The paper will argue that bank taxes, which the Canadian government has opposed on the grounds that they are not needed in Canada, are a good example of this. More generally, there are lessons to be learned not just about the interactions of Canadian practices with the local Canadian context, but also about the interaction of Canadian practices with transnational practices. These lessons are relevant to developing countries as they consider their relations with these rapidly evolving transnational practices.

Drawing the connections between Canadian practices and their local and transnational contexts, and avoiding the transfer and use of models without regard to their contexts, is consistent with one of the lessons that the crisis has made very clear. History and

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Financial Meltdown New York: Pantheon. For his argument about Canadian banks see Peter Boone and Simon Johnson (2010) ñThe Canadian Banking Fallacyò and the comments attached to it, at http://baselinescenario.com/2010/03/25/the-canadian-banking-fallacy/, accessed May 13, 2010.

institutional contexts matter, whether we are talking about particular risk models or larger regulatory models.[6]

The paper starts by summarizing the factors that seem most likely to have contributed to the success of Canadian banks. It then considers the local and transnational contexts in turn. The concluding section draws out the lessons these offer for other countries, especially in the developing world.

Why Canadian banks did well during the crisis

The following seven factors have been widely seen as important in the success of the Canadian banks.

1. Good strong prudential bank regulator: OSFI is a national regulator that is entirely devoted to prudential regulation. Julie Dickson, head of OSFI, has received much praise for the skill and forcefulness of her supervision. She attends bank board meetings at least once a year, sometimes without the attendance of bank executives.[7] OSFI has a reputation for working aggressively but flexibly with banks to anticipate and mitigate risks. It has the power to issue guidance and interpretations of guidance, and to bring about compliance with these. Canadian regulators see OSFIÕs principles-based supervisory approach, which relies significantly on the internal practices of the banks, as important to their success.[8] According to Ed Clark, CEO of TD Bank, ÒThe message in the US is itÕs your responsibility to meet our rules. In Canada, the responsibility is to run the institution right. Julie says [to the CEO]: you are the chief risk officer of the bank.Ó[9] The Bank of Canada is responsible for monetary policy, lender of last resort functions, and oversight of payment and settlement system. Securities markets are regulated provincially, but federally-regulated banks play a key role in those markets. In the late 1980s banks were allowed to purchase investment dealers, and this has brought those operations under OSFIÕs strict supervision, in contrast to the anemic regulation of US investment firms by the SEC.[10]

2. Capital-asset ratios: Before the crisis Canadian bank capital was not necessarily higher than other banks that were more troubled (for instance Wachovia failed with a equity/asset ratio of 16.9, as compared to the highest ratio of the big Canadian banks, TD, at 5.7).[11] Nevertheless Canadian banks overall were required by OSFI to be well

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[6] On the problem of decontextualized risk models and the crisis see Tony Porter (2010) ÒRisk Models and Transnational Governance in the Global Financial Crisis: the cases of Basel II and the Credit Rating Agencies,Ó in Eric Helleiner, Stefano Pagliari and Hubert Zimmerman, eds., *Global Finance in Crisis: The Politics of International Regulatory Change*, (London: Routledge), pp. 56-73.
[7] Chrystia Freeland (2009) ÒView from the Top: Julie Dickson, Superintendent, OSFIÓ [interview] *Financial Times*, December 21, and ÒWhat Toronto Can TeachÉ Ó
[8] Northcutt et al, p. 48.
[9] Quoted in Freeland, ÒWhat Toronto Can TeachÉ Ó
[10] Heinrich, Erik (2008) ÒWhat CanadaÕs Banks DonÕt Need Help,Ó *Time* November 10, athttp://www.time.com/time/business/article/0,8599,1855317,00.html#ixzz0neFH7BN9, accessed May 11, 2010.
[11] Lev Ratnovski and Rocco Huang (2009) ÒWhy are Canadian Banks More Resilient?Ó IMF Working Paper WP/09/152, Table 2, p. 7.

capitalized. OSFI requires Canadian banks to hold 7% of Tier 1 capital and 10% total capital, above the Basel II requirements of 4% and 8%.[12] Canadian Tier 1 requirements were the highest among the G7. Moreover OSFI insists on high quality Tier 1 capital: 75% or more must be common equity. Single name exposures are limited to 25% of regulatory capital.[13]

3. Leverage cap: Among the G7 countries only Canada and the US regulators impose leverage caps on their banks. OSFI included some off-balance sheet exposures in its definition of assets that the US did not, including credit derivatives. The Canadian leverage cap was a maximum asset to capital (Tier 1 and 2) ratio of 20, while the US ratio (on Tier 1 only) was 33.5% for banks thought to be stronger and more sophisticated and 25% for other banks.[14]

4. Market structure and practices: The Canadian banking industry, which is dominated by the top five banks, is very concentrated. Banks are permitted to engage in securities markets and insurance, although the latter must be separated organizationally from the rest of the bank. At the same time Canadian authorities have acted decisively to prevent further consolidation: in 1998, despite enormous pressure from the industry, the government refused to allow mergers. The relatively small number of banks is seen as facilitating regulation.[15] Their domination of nation-wide retail banking has shielded them from international competition as has the ñwidely-heldò rule, which traditionally has limited the holding of any one shareholder of the main ñSchedule 1ò banks to 10% of all shares. In 2006 foreign banks only accounted for 7% of bank assets in Canada.[16] The widely-held rule also limits concentration. Canadian banks are unusual among OECD banks in the share of depositary funding to total assets.[17] Banks relying more heavily on wholesale funding found their funding evaporating during the crisis. Canadian banks retained a far higher share of mortgages on their books than did US banks, thereby giving them a stronger interest in the long-range financial health of the mortgages. The Canadian bank market structure has contributed to consistent profitability of the industry, and while this has been criticized as harmful to the interests of consumers it also helped with bank resilience during the crisis.

5. Conservative mortgage markets: A 2009 IMF staff report noted that ñOnly 5 percent of mortgages are nonprime and only 25 percent are securitized (compared with 25 percent and 60 percent, respectively, in the United States).ò[18] The Canadian non-prime market was terminated in 2008 when the Canadian Mortgage and Housing Corporation stopped

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[12] Carol Ann Northcutt, Graydon Paulin, and Mark White (2009) ñLessons for Banking Reform: A Canadian Perspective,ò *Central* Banking 19(4), pp. 43-53. The authors are at the Bank of Canada and OSFI. The reference is to p. 46.
[13] Northcutt et al, p. 49.
[14] IMF (2009) ñCanada: Staff Report for the 2009 Article IV Consultation,ò April 17, p. 17, Box 1, at http://www.imf.org/external/pubs/ft/scr/2009/cr09162.pdf, accessed May 11, 2010.
[15] Freeland, ñView from the Topò.
[16] IMF (2008) ñCanada: Financial System Stability Assessmentð Updateò IMF Country Report 08/59, p. 11.
[17] Ratnovski and Huang, p. 11.
[18] IMF, ñCanada: Staff Reporté ò p. 5.

insuring such mortgages.[19] The CMHC is government owned and provides most mortgage insurance. The government also guarantees most private mortgage insurance, although at 90% rather than the CMHCôs 100%. Almost half of residential loans are guaranteed, and mortgages with a modestly high loan to value ratio must be fully insured. Unlike the US mortgage interest is nondeductible, increasing the incentive of homeowners to pay mortgages down quickly. In January 2010 only .45% of mortgages in Canada were in arrears, about a tenth of the rate in the US.[20] Legally, defaulting on loans is more difficult in Canada than the US.[21] During the crisis the government of Canada introduced an Insured Mortgage Purchase Program (IMPP), which ultimately included $125 billion to purchase securitized mortgages from banks. This was arranged to provide liquidity to banks, to free them up to expand their provision of credit, and to level the playing field relative to foreign banks receiving assistance from their governments, but the Canadian government also ensured that the yields of the mortgages they received from banks were greater than the cost of the government debt issued to buy them, thereby making the program profitable for the government.[22]

6. Consumer protection: The Financial Consumer Agency of Canada regulates market-conduct issues. In addition to promoting financial education, it addresses the type of misleading or confusing contract language that contributed to the subprime crisis. For instance in 2008 a Commissioner discovered when investigating a consumer complaint that a bank had violated the law by not disclosing when an annual fee would take effect. After the bank modified its forms and procedures the Commissioner decided not to impose the $5000 fine that had been proposed.[23]

7. Canadian culture. The idea that Canadians are culturally more conservative and boring than Americans is widespread. For instance Matt Winkler, editor-in-chief of Bloomberg News, noted ñCanadians are like hobbits. They are just not as rapacious as Americansò According to Roger Martin, Dean of the Rotman School of Business at the University of Toronto ñWe are ópeace, order and good governmentô. They are into the pursuit of happiness. The US banks were pursuing their own happiness, with sort of an ideological assumption that it would all work out fineò.[24]

As a whole the seven factors contributing to the success of Canadian banks point to some lessons relevant for other countries. Two of the more technical factors appear to be especially generalizable. Adequate levels of bank capital relative to assets, which was

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[19] Northcutt et al, p. 47.

[20] Canadian Bankers Association (2010) ñCanadaôs Strong Banking System: Benefiting Canadians,ò April, p. 2.

[21] Keith B. Richburg (2008) ñWorldwide Financial Crisis Largely Bypasses Canada,ò *Washington Post*, October 16.

[22] See Jean-François Nadeau (2009) ñThe Insured Mortgage Purchase Program,ò Parliamentary Information and Research Service, Canadian Library of Parliament, March 13.

[23] Financial Consumer Agency of Canada (2008) ñCommissionerôs Reasons for Decision,ò Decision 102, posted September 19, 2008, issued February 2008, at http://www.fcac-acfc.gc.ca/eng/industry/CommDecisions2/PDFs/102-eng.pdf
May 11 2010.

[24] Quotes from Freeland, ñWhat Toronto can Teaché ò

important in Canada, has also been recognized as important worldwide, and measures to strengthen capital have been taken both by the Basel Committee on Banking Supervision, which sets standards globally for bank regulation, and by authorities at the national level. In its proposed revisions to Basel II the Basel Committee has noted ñit has been possible for some banks under the current standard to display strong Tier 1 ratios with limited tangible common equityò. Now ñthe predominant form of Tier 1 capital must be common shares and retained earningsò.[25] As noted above, the emphasis on common shares in Tier 1 capital has been seen as having contributed to the resilience of Canadian banks. Similarly the leverage ratio, which provides a more simple and comparative constraint on banks than the Basel II risk-weighted capital-asset ratios, and which was important in Canada, has now become a priority in the work of the Basel Committee.[26] This work by the Basel Committee is mandated, reviewed and endorsed by the G20.

It is also certainly clear that Canadian banks were more strictly regulated, that the Canadian state played a more assertive role in the financial system, and that banks accordingly avoided more of the excessively aggressive market practices than was the case in the US and other jurisdictions that were harder hit by the crisis. These excessively aggressive practices included the marketing of risky and opaque sub-prime mortgages; the speculation in housing by home-owners and investors that fueled the housing bubble; the originate-to-distribute model and complex forms of securitization that hid risk and eroded incentives to take responsibility for risks; the excessive reliance on leverage, especially by certain big banks but also by homeowners; the pursuit by banks of growth strategies based on expanding sources of wholesale funding and newer more complex investments or the creation of new complex fee-based structured financial products; and a failure to pay sufficient attention to risk management within banks.

The Canadian experience is therefore a testament to the importance of regulation and restraint on the most risky bank activities in preventing crisis. As such it is a repudiation of pre-crisis conventional wisdom favoring heavy reliance on markets and ñlight-touchò regulation. For instance one extensively researched and widely cited pre-crisis book by Barth and Caprio, which examined bank regulation across the world, strongly concluded that the risk of malfeasance from regulators was worse than the risk of misconduct in markets, and recommended more reliance on accountability through markets, including in developing countries.[27] The Canadian experience, in contrast, confirms the new

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[25] Basel Committee on Banking Supervision (2009) ñStrengthening the Resilience of the Banking Sectorò Consultative Document December, pp. 4, http://www.bis.org/publ/bcbs164.pdf?noframes=1, accessed May 13, 2010.

[26] As the Basel Committee noted, ñthis will help contain the build up of excessive leverage in the banking system, introduce additional safeguards against attempts to game the risk based requirements, and help address model risk. To ensure comparability, the details of the leverage ratio will be harmonized internationally, fully adjusting for any remaining differences in accounting.ò Basel Committee on Banking Supervision (2009) ñStrengthening the Resilience of the Banking Sectorò Consultative Document December, pp. 2-3, http://www.bis.org/publ/bcbs164.pdf?noframes=1, accessed May 13, 2010.

[27] Barth, James R., Gerard Caprio, Jr. (2006) *Rethinking Bank Regulation: Till Angels Govern* (Cambridge: Cambridge University Press). The book has some nuance in recognizing that democracy can also be an important source of accountability. Certainly its arguments that regulators can be captured or can operate in their own self interest at the expense of the public interest should continue to be taken seriously. However

conventional wisdom: that stronger regulation can produce more stable and successful outcomes through the whole cycle, including bubbles and crises.

The Canadian experience also provides support for the view that it is important to include both simple transparent rules and aggressive discretionary supervision in bank regulation. A widely recognized deficiency of pre-crisis regulation, especially Basel II, was its mixture of complexity and reliance on bank discretion (for instance in permitting the use of internal risk models). This mixture is a recipe for banks to conceal or ignore risks, and it also exacerbates the risk of capture, since the complexity can insulate banks and regulators from external scrutiny. The use of a simple leverage ratio is one way to offset this problem of complexity and lack of transparency. Aggressive discretionary supervision, such as has been exercised by OSFI, can also help in preventing banks from gaming the rules or using unscrutinized internal rules as a justification for lax risk management.

Despite these lessons provided by the Canadian experience, there are other Canadian practices, such as Canadian culture, that arenôt as easily transferred. In order to further assess the transferability of Canadian practices it is useful to move beyond treating them as separate items that can be ordered *à la carte* and to analyze the contexts within which they operate.[28]

Canadian practices in their Canadian context

In recent decades there has been considerable interest in persistent differences in the structure of national financial systems. It is useful to consider this research in assessing the transferability of lessons from Canada to other jurisdictions. This research varies in the degree to which it sees convergence to a single model of finance occurring. One line of research has been inspired by Goldsmithôs path-breaking empirical analysis of an apparently universal historical trend towards finance growing relative to GDP across all jurisdictions.[29] This literature is not inconsistent with economic arguments that see financial markets as playing a central positive role in development and growth by mobilizing and allocating capital efficiently. Alternatively, Gerschenkronôs identification of a difference in the financial systems of late industrializers, like Germany, which relied heavily on banks and early industrializers, like Britain, which relied more heavily on capital markets,[30] has inspired research on persistent national differences in financial

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the crisis confirmed that they greatly underestimated the risks associated with relying on markets to hold firms accountable.

[28] By transferable I mean policy transfer, which can include imitation, or the drawing of positive lessons. It should be noted that Canadian banks were not immune from the problems that destroyed banks in other countries. CIBC took a $3.5 billion charge on mortgage backed securities and the banks were involved in the freezing of the asset backed commercial paper market. See Andrew Coyne (2009) ñOur So-Called Genius Banks,ò *Macleans*, April 6, at http://www2.macleans.ca/2009/04/06/our-so-called-genius-banks/, accessed May 12, 2010. However these problems were relatively minor compared to problems in other countries.

[29] Raymond Goldsmith (1969) *Financial Structure and Development* (New Haven: Yale University Press).

[30] Gerschenkron, Alexander (1962), *Economic backwardness in historical perspective, a book of essays*, (Cambridge, MA: Belknap Press).

systems that seem to be linked to historical path dependencies, such as the functional need for greater centralized coordination in the financial systems of late industrializers needing to break out of an existing world division of labour while subject to intense competitive pressures from early industrializers.[31]

In the varieties of capitalism literature these national differences have been seen as reflecting national interdependencies and complementarities that come in different coherent packages, which may each perform well, but in different ways.[32] Financial systems in liberal market economies, like other aspects of these systems, do especially well in launching new innovations (for instance through venture capital markets), while financial systems in coordinated market economies do especially well in long-range investments designed to perfect an existing technology (for instance through close and long-range links between banks and industry). Recent empirical research on the relative performance of financial systems oriented towards capital markets and financial systems oriented towards bank-intermediated finance suggests that there is no significant difference between the two with regard to development and growth.[33]

A literature on the historical development of the Canadian political economy has linked the strength, concentration, and national ownership of Canadian banks to Canadaôs distinctive colonial history. In the colonial period the Canadian economy was built on the exports of primary products like furs, fish, and wheat, to Europe. This economy required financing of these commercial activities, including trade finance and investment in transportation infrastructure, and Canadian banks supplied this, but in a way that consolidated the control of a commercial elite and stunted industrial development.[34] While this literature tended to prescribe nationalist state-oriented interventions to promote more robust Canadian industrial development, its analysis is not entirely inconsistent with liberal economic analysis which sees the colonial stranglehold over the Canadian economy as inhibiting the emergence of a more venturesome set of small banks and local capital markets that may have contributed to the early more rapid industrialization and growth of the US.[35] Whatever the effects of this early period, it

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[31] John Zysman (1983) *Governments, Markets, and Growth: Finance and the Politics of Industrial Change* (Ithaca: Cornell University Press).

[32] Peter A. Hall and David W. Soskice (2001) *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press).

[33] See Demirgüç-Kunt, Asli and Ross Levine (2001) ñFinancial Structure and Economic Growth: Perspectives and Lessonsò in Asli Demirgüç-Kunt and Ross Levine, eds., *Financial Structure and Economic Growth* (Cambridge Mass: MIT Press), p. 12, which notes ñOverall financial development matters for economic success, but financial structure per se does not seem to matter much. Thus, policymakers may achieve greater returns by focusing less on the extent to which their country is bank-based or market-based, and more on legal, regulatory and policy reforms that boost the functioning of markets *and* banks.ò

[34] See for instance Wallace Clement (1975) *The Canadian Corporate Elite: An Analysis of Economic Power* (Toronto: McClelland and Stewart) and Wallace Clement (1977) *Continental Corporate Power* (Toronto: McClelland and Stewart). For an overview of the distinctive Canadian ñstaples political economyò literature see Michael Howlett and M. Ramesh, (1992) *The Political Economy of Canada: An Introduction*, (Toronto: McClelland and Stewart), Chapter 4.

[35] For such a liberal economic approach see Richard Sylla (2006) ñPolitical Economy of Financial Development: Canada and the United States in the Mirror of the Other, 1790-1840ò, *Enterprise & Society* 7(4), pp. 653-65.

certainly contributed to the current strength, concentration, and national ownership of Canadian banks, and this is therefore an aspect of the Canadian system that is less easily transferable to other contexts with different histories.

Recent research has also brought housing systems into this type of comparative analysis of national economic and financial systems. Schwartz and Seabrooke have labeled identifiable differences in housing systems across jurisdictions as ñvarieties of residential capitalismò.[36] While these do not correspond well with the liberal market economy/coordinated market economy distinction in the varieties of capitalism literature they do as well appear to come in nationally distinctive packages. They identify two dimensions on which these vary: the relative shares of owner-occupied housing and rentals, and the value of mortgages relative to GDP. Culturally countries vary in whether they see housing as a social right, as a family good that should not commodified, or as an investment and source of personal wealth. Liberalized financial systems with high degrees of securitization contribute to the treatment of houses as personal investment vehicles. These systems also correlate with political pressures for low taxes (to facilitate personal investment in houses which substitute for social mechanisms for mitigating risk such as public pensions or social housing) and low inflation (which keeps interest rates low and boosts house prices). They also correlate with growing social inequality as some younger and poorer people find their rents increasing and houses becoming increasingly difficult to purchase, while older homeowners enjoy dramatic leveraged asset accumulation from the increases in house prices.

On a global scale Schwartz argues that countries with highly securitized housing finance, especially the United States, were able before the crisis to absorb low-cost debt financing from abroad, convert this into rapid economic growth, while also financing the innovation and higher value investments abroad to cover the cost of debt owed to foreigners.[37] In contrast countries with more traditional restricted housing finance systems grew significantly more slowly. However with the crisis the securitized systems that had produced positive growth synergies went disastrously into reverse.

These literatures on historical differences in financial systems have implications for the transferability of successful Canadian practices to other jurisdictions. They highlight the importance of not just considering the performance of particular stand-alone regulatory instruments or industry practices, but instead to consider these in relationship to the larger context in which they function. These instruments and practices may not function well in a different context. Moreover financial growth and stability is linked to, and should not be pursued in isolation from other public policy goals such as housing, employment, or fairness with regard to the distribution of income and wealth.

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[36] See Herman Schwartz and Leonard Seabrooke (2008) ñVarieties of Residential Capitalism in the International Political Economy: Old Welfare States and the New Politics of Housingò, in *Comparative European Politics* 6(3), September, pp. 237-61, and the other articles in this special issue.

[37] See Herman Schwartz (2009) ñHousing, Global Finance, and American Hegemony: Building Conservative Politics One Brick at a Timeò, *Comparative European Politics* 6(3), September, pp. 262-84, and Herman Schwartz (2009) *Subprime Nation: American Power, Global Capital, and the Housing Bubble* (Ithaca: Cornell University Press).

The interconnectedness of instruments and contexts is evident in the seven factors contributing to the success of Canadian banks. For instance the quality of OSFI as a prudential regulator appears to be complemented by the market structure of Canadian banks: the industryôs oligopolistic structure, national focus, and the resulting consistently high level of profits that it enjoys contributes to OSFIôs ability to supervise the industry. OSFIôs principles-based approach with its heavy reliance on close relations with bank boards and trust in the internal organization and practices of the banks it regulates most likely would not work as well in a market characterized by a large number of small banks, or by foreign-owned banks run from head offices outside Canada. Bank structure, with its coast-to-coast retail banking and the stable funding based on deposits that result, similarly contributes to the conservatism of the mortgage market. Canadian culture interacts with all the other factors. This interdependence means that care must be exercised in assessing whether practices can be transferred individually or if they only function well as a package.

The interdependence of the factors contributing the Canadian resilience is also important because of its significance for the complex interconnected character of contemporary crises. The literature on disasters, crises, and risks suggests that the complexity of our contemporary societies makes the origins and spread of the effects of crises more unpredictable. A blend of centralized coordination and decentralized risk mitigation capacity appears to be the optimal response to these risks, whether in earthquake preparations or financial regulation.[38] The Canadian blending of clear rules (for instance on Tier 1 capital or leverage), aggressive discretionary supervision, and governance mechanisms that stabilize the environment within which banks operate (such as the mortgage market) are well suited to the character of contemporary systemic risks.

The importance of considering the broader implications of financial practices for non-financial policy goals is illustrated by the shortcomings of the Fraser Institute report written by Mohindra which advocates the privatization of Canada Mortgage and Housing Corporation, mentioned in the introduction to this paper. The subheading of the report ñprotecting taxpayers from liabilityò already indicates that the performance of Canadian mortgage finance is being judged in relationship to a particular goal outside the financial system: limiting taxes. The text of the report points to the very large risks that the government owned CMHC is taking on in its guarantee of mortgages, and argues that if it was privatized these risks would be shifted to the private shareholders of mortgage finance insurers. It approvingly offers as evidence the Australian case, where mortgage insurance is private and where it argues that house ownership levels and financial stability are comparable to Canadaôs.

A problem with this argument is that while the value of mortgages that the Canadian government has insured is huge, the risk to which it is exposed is also determined by the probability that the mortgages will default, and with a default rate below 1% probability is very low. Even as the Canadian housing market was looking significantly overvalued

[38] These points have been explored in Tony Porter (2009) ñCatastrophic risk management failures in global financial and environmental governance,ò Paper prepared for CIGI workshop on finance and the environment, Waterloo, September 24-5, 2009.

in early 2010 it did not possess the other key destructive ingredients that provoked the US subprime crisis. Moreover it is not at all clear that private insurers could provide the required buffer and inspire confidence in times of crisis. Private insurance in the form of credit default swaps (CDS) failed miserably in the US subprime crisis and contributed to the severity of the crisis, and ultimately the US government stepped in to bail out AIG from its system-threatening CDS troubles.

A problem with the Australian evidence that the report presents is that by focusing narrowly on the performance of the residential mortgage market and on owner-occupied housing it underestimates the connections of these to broader issues. It is not clear that the Australian housing system has performed as well as the Canadian. According to the report (p. 56) homeownership rates in Canada increased from 65.8% to 68.4% between 2001 and 2006, while comparable Australian rates declined from 70.3% to 69.3%.[39] In their analysis of the Australian variety of residential capitalism Mortensen and Seabrooke argue that this decline reflects the increased difficulty for young people to access housing. The generational divide between renters and first time homebuyers on the one hand, and older homeowners and investors in rental property on the other, has widened, accelerated by tax policy favouring landlords. In 2006 the average household needed seven times after-tax disposable income to afford a house, up from five times in 1996. Intergenerational dissatisfaction about housing availability was a key factor in the Australian Labor Partyôs landslide electoral victory in 2007. [40] Since such strong dissatisfaction has not been as evident in Canada it suggests that the Canadian system may be outperforming the Australian one in this respect.

A major challenge in housing policy is how to help poorer first time homeowners purchase their first house. The US subprime experience failed catastrophically to contribute to this goal. The more purely market-oriented Australian experience has also not been sufficiently successful. Markets, including residential property markets, can shift resources toward those who already have assets. More research is needed to fully understand the impact of different mortgage finance models on this problem, but the government owned CMHC appears to have performed better on this than have the US or Australian systems. More generally, it is important to consider the broad effects of regulations on policy issues other than financial stability, including the problem of financial exclusion.[41]

The following conclusions about the transferability of Canadian instruments and practices can therefore be drawn from this section. First, it is important to consider the context within which each instrument and practice functions before advocating their adoption elsewhere. For instance an oligopolistic banking structure works well in Canada, but it

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[39] Mohindra (2010) ñMortgage Finance Reformé ò p. 56

[40] Jens Ladefoged Morgensen and Leonard Seabrooke (2009) ñHousing as Social Right or Means to Wealth? The Politics of Property Booms in Australia and Denmarkò *Comparative European Politics* 6(3), September, pp. 305-24. The data cited are from pages 316 and 319.

[41] On recent research on financial exclusion see Wayne Simpson and Jerry Buckland (2009) ñExamining Evidence of Financial and Credit Exclusion in Canada from 1999 to 2005,ò *Journal of Socio-Econoomics* 38, pp. 966-76. It cites evidence that 3% of all Canadian households and 8% of low-income Canadian households are unbanked, but notes that this is likely to be an underestimate (p. 968).

would be unwise to transfer this without considering the connection of its success to the retail networks and the cheap stable funding this provides, or to the strong aggressive regulation that OSFI provides, not all of which will accompany all oligopolistic bank markets. Similarly heavy government involvement in residential mortgages through the CMHC works well in Canada, but the implicit US government guarantees of Fannie Mae and Freddie Mac in the US were disastrous because they were not accompanied by strict regulation of these two ostensibly private institutions, and because of the unrestrained risk taking that was occurring elsewhere in the US housing market, that spilled over into the problems of Fannie and Freddie.

A response of the Canadian Bankers Association (CBA) to the Basel Committeeös proposals for strengthening global bank regulation standards provides an example of the use of a Canadian lesson without adequate consideration of context. After citing five factors which the CBA sees as having contributed to Canadian resilience, the CBA then comments ñThe Canadian experience clearly demonstrates that effective principles-based regulation is more effective and we would caution against over-reliance on rules-based regulation.ò[42] However, as noted above, the Canadian success with principles-based regulation was dependent on certain factors, such as the ability of OSFI to aggressively examine and correct an oligopolistic banking industry, and these factors may not be present in other jurisdictions. Taken out of context this advocacy of principles-based regulation could be used to deter the creation of new rules that may be needed to avoid future crises.

Second, it is important to consider the broader normative significance of financial instruments and practices and whether these match with public policy goals. In the US, prior to the crisis, asset accumulation, including in homes, was pursued at the expense of some other crucial public policy goals, including especially financial stability. Following the crisis serious questions are being raised in the US about the wisdom of having such a large share of economic activity be devoted to financial transactions, or of having CEOs receive such high levels of compensation while steering their firms into huge inadequately mitigated risks and financial losses. In Australia some homeowners and investors in residential property are doing well, while younger Australians are having difficulty finding affordable housing. The Canadian system, including the stability provided by the CMHC, has been successful at weathering the crisis, but its transference to developing country contexts without careful consideration of how to help those for whom housing may become more unaffordable, and how to mitigate the gap that will open up between those participating in managing their homes as investments and those who cannot, will invite the types of shortcomings that have been evident in Australia.

Canadian practices in their transnational context

The 2007-2008 crisis was another stark reminder of the way in which the causes and effects of crises spill across borders, as was the case with the debt crisis of the early 1980s and the global financial crises of the 1990s. Recognition of this interdependence

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[42] Canadian Bankers Association (2010) ñCBA Comments on the Basel Committeeös Consultative Document óStrengthening the resilience of the banking sectorôö April 16, p. 2 of cover letter.

has led governments and regulators to construct a complex set of collaborative networks for sharing information and setting standards. The creation of the Financial Stability Forum (FSF) and the G20 in 1999, following the East Asian crisis, marked an important additional degree of institutionalization of these arrangements, as did the replacement of the G8 by a regular G20 summit and the replacement of the FSF by the more structured and representative Financial Stability Board in response to the 2007-8 crisis. A strong commitment to further develop agreed transnational financial standards has been expressed by the G20 governments. However, reconciling this trend towards more harmonized standards with the importance of differing local contexts that was discussed in the previous section remains a serious challenge. This section asks what the Canadian case can tell us about this.

The severity of this problem of reconciling national contexts and transnational collaboration has been evident in a number of issues that have been serious obstacles to states being able to develop an effective response to the crisis. In addition to inadvertent clashes that result from national policy being driven by local contexts, the pursuit of competitive concerns can exacerbate these obstacles. In a study of specific post-crisis policy or regulatory proposals favoured by the US, the UK, France and Germany, Mügge provided evidence showing how closely those positions matched up to the interests of the industry in each country.[43] High profile disagreements between states that relate to national differences have included the European antipathy to US proposals to restrict proprietary trading in deposit-taking institutionsð ie. the ñVolcker ruleò which would shift the US back towards an earlier period when investment and commercial banking were separated. In Europe most banks have always been universal. In contrast the Europeans strongly favour further development of Basel II, which has been integrated into EU rules, while the US, which has not committed to applying Basel II to all its banks, has been much less enthusiastic about developing it.[44]

Through most of the crisis Canada has been in the enviable position of having its national interests and local context match up with its global role. Some of the seven qualities of the Canadian financial system discussed above were seen as restricting Canadian competitiveness prior to the crisis. For instance the relatively staid Royal Bank of Canada was unfavourably compared to the aggressive Royal Bank of Scotland, which would subsequently require the worldôs largest infusion of government money to prevent its

[43] Mügge, Daniel (2010) "Paradigm Shifts in Post-Crisis Financial Regulation? A Comparison Across Domains and Polities" Paper presented at the annual meeting of the Theory vs. Policy? Connecting Scholars and Practitioners, New Orleans Hilton Riverside Hotel, The Loews New Orleans Hotel, New Orleans, LA, Feb 17, 2010
Available:
http://www.allacademic.com/meta/p_mla_apa_research_citation/4/1/3/0/9/p413099_index.html

[44] On these tensions see Gillian Tett (2010) ñGlobal Fiscal Reform Hangs in the Balanceò, *Financial Times (London)*, February 1, which notes ñtwo weeks ago the White House startled the banking world by unveiling the so-called Volcker reform plan, without a token nod towards co-ordination with the rest of the G20. Thus, the question that regulators and bankers are trying to answer is whether the US is intent on going it alone on the regulatory front - or could it be persuaded to co-operate with other governments via the Financial Stability Board? At the weekend, non-Americans were trying to put on a brave face. There was profound irritation among some European leaders that they had not been informed of the White House plans.ò

collapse.[45] The seven qualities were not primarily driven by transnational pressures. Higher than required capital adequacy levels, the leverage ceiling, restrictions in the mortgage market, and strong regulation are all examples of measures that resisted the problematic risk-inducing competitive pressures from outside Canada, but more for Canadian purposes than in response to transnational harmonization. Once fortified with these qualities the Canadian financial system was positioned to benefit from the crisis, as most evident in the dramatic rise of Canadian banks in global bank rankings. The $125 billion IMPP and other assistance provided by the Canadian government to banks was in large part motivated by the negative competitive implications of Canadian banks lacking government guarantees when such guarantees were being provided by other governments to their banks. However even this more mercantilist motivation was not inconsistent with global interests in systemic stability.

Canadian officials have been very active in seeking to improve transnational regulatory institutions and standards. For instance Tiff Macklem, G7 Deputy and Associate Deputy Minister of Finance of Canada chairs the FSB Standing Committee on Standards Implementation, which is responsible for managing the FSBôs new peer review process.[46] Macklem also co-chaired (with Rakesh Mohan of India) G20 Working Group 1 on Enhancing Sound Regulation and Strengthening Transparency. This builds on a long tradition of Canadian involvement in financial governance issues, including for instance Canadaôs prominent role in launching and hosting the G20 in 1999. In 2009-10 this was further enhanced by Canadaôs hosting of the G8 and G20 meetings. In this as well, Canadian national interests and global interests overlap. As in any race to the bottom, well regulated actors have an interest in raising the standards of their competitors.

In contrast the vigorous Canadian campaign against G20 initiatives to tax banks displayed a clash between Canadian national interests and global interests. Government rhetoric sought to frame the Canadian position as virtuous: why should well functioning banks be unfairly punished by being taxed?[47] This is arguable in the Canadian context since the Canadian government certainly had to spend money to offset a crisis that had resulted from risky activities from which Canadian banks had also profited from, even if less aggressively than banks from other countries. Moreover it risks appearing hypocritical when the government stepped in vigorously with the IMPP to bring its support for Canadian banks closer to its competitors: harmonize when it benefits Canadian banks but not when it doesnôt. For global systemic stability there are strong

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[45] Freeland, ñWhat Torontoé ò; Kowsmann, Patricia (2010) ñNAB to conduct due diligence on UK RBS branches: sourceò, *Dow Jones Newswires* May 13, 2010, http://www.theaustralian.com.au/business/industry-sectors/nab-to-conduct-due-diligence-on-uk-rbs-branches-source/story-e6frg96f-1225865813684, accessed May 12, 2010..

[46] FSB (2010) ñFSB Announces Future Peer Reviews,ò Press release, March 30, at http://www.financialstabilityboard.org/press/pr_100330b.pdf, accessed May 12, 2010. As of July 1 2010 Macklem will be appointed Senior Deputy Governor of the Bank of Canada.

[47] As Flaherty put it ñAs finance minister of Canada, I am not going to impose a tax on our banks that performed well during the financial crisis. It seems to me a very odd thing to do, to punish our banks who got the job done admirably.ò Quoted in Lee-Anne Goodman (2010), ñFlaherty Holds Firm in Resistance to G20 Bank Tax, Calling it Punitive,ò *Canadian Business*, April 22, at http://www.canadianbusiness.com/markets/headline_news/article.jsp?content=b221019417, accessed May 12, 2010.

reasons to consider coordinated bank taxes. Without coordination the tax would not work: activity would migrate to untaxed jurisdictions. The tax could be risk-weighted or size-weighted to discourage the types of practices that led to the crisis and it could help those countries that have needed or will need to spend large sums of money correcting the problems created by the financial system. While there are good reasons to enter into a good faith debate about the advantages and disadvantages of a bank tax, and how to implement it, the unrelenting Canadian opposition and its rhetorical framing as concerned about the interests of Canadian banks rather than about the taxọs contribution or not to global financial stability strongly suggests that the Canadian position is motivated by its placing of its interest in the competitiveness of its banks over its interest in collaboration to promote global systemic stability.[48]

What are the implications of this section for the transferability of successful Canadian instruments and practices to other countries? One implication is that not all Canadian practices are motivated by stability goals that deserve emulationð some of them are at least in part expressions of idiosyncratic Canadian national interests. A second implication is that it is a lot easier to be virtuous when national and global interests are aligned, and more difficult when they are not. A third is that governments in Canada and elsewhere should not only concern themselves with national stability. They should take very seriously the collective benefits that come from strong coordinated global standards, and the sacrifices that most countries will have to make on some issues in order to achieve this. Canadian authorities deserve credit for resisting competitive pressures before the crisis, but their more narrowly self-interested campaign against bank taxes is not exemplary.

Conclusion: lessons for other countries

The above discussion has identified lessons for other countries from the success of the Canadian at weathering the financial crisis. The first section identified seven factors that contributed to Canadian resilience. Two were more technical and easily transferable: strong bank capital requirements and leverage ratios. As well the general strength of Canadian regulation certainly contributed to Canadian success, and this lesson can encourage strengthening of regulation elsewhere. However the second and third sections identified relationships between Canadian instruments and practices, on the one hand, and local or global contexts on the other, and these relationships require us to think more carefully about the transfer of practices from Canada to other jurisdictions.

A painfully learned lesson of the past decades, especially for developing countries, is that the transnational dissemination of one-size-fits-all models that ignore local distinctiveness can be more destructive than helpful. This should be considered when looking to the Canadian case for lessons. Particular instruments and practices function well because of their interdependence with others, some of which have developed over very long periods of time. Different mixes of state and market influences in financial systems can function equally well in different contexts. This does not mean that historical

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[48] Flaherty noted ñWeỡre a sovereign country; we can regulate our banks and our other financial institutions as we see fit.ò Quoted in Goodman, ñFlaherty Holds Firmé ò.

differences prohibit cross-border learning, but rather that local contexts and differences in the way that national economic and financial systems cohere internally should be carefully considered. In doing so it is important not to pursue the goals of financial stability or growth too narrowly, but instead to consider the effects that changes in the financial system have on society as a whole and on other public policy goals.

For all countries the challenge of reconciling local and national interests and contexts, on the one hand, and global collective interests in strengthening global standards on the other, will increasingly be a challenge even as it has been for Canada, which has escaped most of the harsher effects of the crisis. The seven factors contributing to the success of Canadian banks should not be taken only as Canadian national practices that can be considered for transplantation in different national jurisdictions. Instead all countries are engaged in developing or reproducing practices that are simultaneously part of their national jurisdictions and the global system. In implementing or challenging these practices this should be recognized, and more narrowly national interests that clash with mutually beneficial global ones should be criticized.